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# In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 859

WILLIAM D. FRAZELL AND MARTHA T. FRAZELL,
PETITIONERS

*v.*

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## BRIEF FOR THE UNITED STATES IN OPPOSITION

### OPINIONS BELOW

The opinion of the district court (Pet. 20–45) is reported at 213 F. Supp. 457. The opinion of the court of appeals (Pet. 46–54) is reported at 335 F. 2d 487. The order of the court of appeals denying a petition for rehearing (Pet. 55–56) is not officially reported.

### JURISDICTION

The order denying the petition for rehearing was entered December 15, 1964. (Pet. 55–56.) The petition for a writ of certiorari was filed on January 26, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

## QUESTION PRESENTED

Whether the court of appeals correctly held that the value of property received by the taxpayer as compensation for services to a partnership constituted taxable income.

## STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items:

* * * * *

(26 U.S.C. 1958 ed., Sec. 61.)

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) *General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

* * * * *

(26 U.S.C. 351.)

SEC. 721. NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION.

No gain or loss shall be recognized to a partnership or to any of its partners in the case of a

contribution of property to the partnership in exchange for an interest in the partnership. (26 U.S.C. 721.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.721–1 *Nonrecognition of gain or loss on contribution.*

* * * * *

(b) (1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital repre-

senting compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

(26 C.F.R., Sec. 1.721–1.)

## STATEMENT

William D. Frazell, the taxpayer,[1] is a geologist. In 1951 he entered into an oil venture with Wheless and Woolf. The three agreed that Wheless and Woolf would provide capital for purchasing oil and gas leases in undeveloped property and that the taxpayer would supply his services and technical competence to locate likely mineral producing acreage and to secure contracts for the acquisition of the leases. Although the leases were to be acquired in the names of Wheless and Woolf, it was agreed that the taxpayer was to participate in the profits to a limited extent. When Wheless and Woolf had recovered their full costs and expenses, the taxpayer, upon written request, was to be assigned an interest in the properties. Thereafter, he would be entitled to the portion of min-

[1] Martha T. Frazell is a party only because a joint return was filed.

eral production allocable to his interest, subject to a proportionate share of all future costs and expenses of that production; would be chargeable with a pro rata share of any outstanding indebtedness against the property; and would be entitled to a proportionate share of the proceeds of any sale of the property. Prior to the time of the assignment of his interest to him, the taxpayer was prohibited from disposing of any of his rights under the agreement. In addition, it was agreed that the taxpayer would receive a monthly salary plus expenses. (Pet. 20–23, 46–47.)

The venture was successful. In five years Wheless and Woolf advanced about $1,245,000. Early in 1955 it became apparent that their advances would be recovered and the taxpayer could begin to participate by November of that year. In April 1955, the 1951 contract was terminated and all properties acquired under it were transferred to the W.W.F. Corporation, a corporation formed specifically to receive them. The taxpayer was immediately issued 13 percent of the stock of that corporation, having a fair market value of $91,000. He did not report that amount on his 1955 tax return. The Commissioner included it in his income and determined a deficiency, on the ground that the amount constituted additional compensation for services rendered. (Pet. 23–24, 27–28, 47–48.)

The district court, overruling the Commissioner, held that a joint venture existed among Wheless, Woolf, and the taxpayer from the outset, and the taxpayer exchanged his partnership interest for stock in a tax-free transaction. (Pet. 28–45). The court of appeals reversed, with one dissent, holding that, even

assuming the existence of a joint venture, the $91,000 value of the stock received was income to the taxpayer. It reasoned that his receipt of property—a 13 percent interest in the Wheless-Woolf capital—in return for his services was taxable compensation to him. The court went on to hold that the amount of compensation was to be measured by the fair market value of the stock to the extent that value exceeded the value of any maps contributed by the taxpayer to the venture, if it was found that they were so contributed. It remanded to the trial court for further findings as to whether the maps were contributed to the venture and, if so, their value. (Pet. 46–53, 55–56.)

**ARGUMENT**

1. The decision below is clearly correct. Section 61(a), *supra,* subjects to tax "all income from whatever source derived, including * * * [c]ompensation for services * * *." If property, instead of money, is received as compensation, the fair market value of the property is the measure of income. If the property has no value when received or if the taxpayer's actual command and control over it is substantially fettered—factors which may be interrelated—he does not realize income until the property gains value or until the restriction is removed. See *Commissioner* v. *Smith,* 324 U.S. 177, rehearing denied, 324 U.S. 695; *Commissioner* v. *LoBue,* 351 U.S. 243. The rule is the same when the property received is a capital interest in a partnership or a joint venture. Section 1.721–1(b)(1) of the Treasury Regulations explicitly provides that—

> To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 [providing for nonrecognition of gain or loss upon the contribution of property to a partnership in exchange for an interest in the partnership] does not apply. *The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.* * * * [Emphasis added.]

In light of these principles, it is clear that Frazell was taxable in 1955 on the fair market value of the property (be it stock or a partnership interest) which he received as compensation for his services. Prior to 1955, Frazell's interest in the partnership, if any, was restricted as to alienation and contingent upon the existence of profits sufficient to match the capital contributions of the other venturers. In the words of the court below, it was "a springing executory interest" (Pet. 50) not yet taxable. If the 1951 contract had remained in effect, Frazell's partnership interest would have become possessory in November 1955, the end of the payout period; with the restrictions thus removed and the conditions precedent fulfilled, the interest would at that point have been taxable as compensation for services. Similarly, if the parties had agreed at the outset that Frazell's services would be compensated at the end of the payout period by the issuance of stock in the W.W.F. corporation, the fair market value of that stock would have been

taxable upon receipt. The transfer would not qualify for non-recognition treatment under Section 351(a), which specifically provides that "stock or securities issued for services shall not be considered as issued in return for property." The result should be no different, we submit, merely because the parties, having originally agreed that Frazell's compensation should take the form of an interest in the partnership capital, later changed their minds and converted that interest into W.W.F. stock shortly before its maturity. However the 1955 transaction be characterized, the basic fact remains that Frazell received in that year a fixed, definite, and therefore taxable interest in the business as compensation for his earlier services.

It makes no difference whether the W.W.F. stock is deemed to have been received (a) in return for the services themselves (with the partnership interest simply being extinguished upon the rescission of the contract); or (b) in return for Frazell's contingent interest in the partnership capital. Even on the latter assumption, the transaction is immediately taxable. For by converting it to stock, Frazell realized the full economic benefit of his right to compensation under the 1951 agreement just as if he had waited for the partnership interest to become possessory in November 1955. Cf. *Helvering* v. *Horst,* 311 U.S. 112, 117. Innumerable cases in the capital gains field have recognized that the sale or other disposition of a right to future compensation (or other ordinary income) constitutes merely a present realization of the income to which the right pertains, and that the property received upon such a disposition is to be taxed in the

same way as the income itself would have been.[2] Such transfers have never been regarded as the sale of a "capital asset" within the meaning of Section 1221 and, by the same token, should not be regarded as a transfer of "property" within the meaning of Section 351(a). In sum, property (here stock) received by a taxpayer in return for a right to future taxable income as compensation for services (here the contingent right to a partnership interest) is immediately taxable as ordinary income whether it be regarded as a *quid pro quo* for the services themselves or for the claim to compensation for those services.

We have assumed up to this point that the taxpayer's interest, or potential interest, in the joint venture was an interest in the partnership capital and as such would have constituted income to him when received, as provided by § 1.721–1 of the regulations, supra. Taxpayer argues, however, that the other venturers did not give up a capital interest in his favor; that all he acquired, or would have acquired, was a "share in partnership profits"; and that such an interest is expressly excluded from the purview of the regulation (Pet. 2, 10–11). That contention is groundless. While it is true that Frazell's interest was not to become possessory until Wheless

[2] See *Commissioner* v. *Gillette Motor Transport Co.*, 364 U.S. 130, 134–135; *Commissioner* v. *P. G. Lake*, 356 U.S. 260; *United States* v. *Woolsey*, 326 F. 2d 287 (C.A. 5); *Bisbee-Baldwin Corp.* v. *Tomlinson*, 320 F. 2d 929 (C.A. 5); *United States* v. *Eidson*, 310 F. 2d 111, on rehearing 312 F. 2d 744 (C.A. 5); *Commissioner* v. *Ferrer*, 304 F. 2d 125, 133–134 (C.A. 2); *Holt* v. *Commissioner*, 303 F. 2d 687 (C.A. 9); *Wiseman* v. *Halliburton Oil Well Cementing Co.*, 301 F. 2d 654 (C.A. 10).

and Woolf had recovered their costs and expenses from the proceeds of the oil, the amount so recovered by the latter was not a return of their capital investment, but a return *on* their investment, *i.e.*, as the court below termed it (Pet. 56), "a skimming of profits" of the venture (presumably taxable to them as income). Moreover, the district court specified that (Pet. 22, 23) the taxpayer, after the payout to the other venturers, was to have an interest in the oil and gas properties and that he was to participate in any proceeds from their sale. His ultimate receipt of a share of the corporate capital through his stock ownership confirms the capital nature of his interest in the partnership.[3]

2. There is no conflict. In *Farris* v. *Commissioner*, 222 F. 2d 320 (C.A. 10), cited by the taxpayer, the contributing partner relinquished and the service partner received a full participating interest in the partnership capital in 1943, the first year of the venture. Although he should have included the value of

[3] Moreover, even if the taxpayer had only a net profits interest, that would still not shield him from taxation on the transfer of that interest to the W.W.F. corporation in exchange for its stock. The most it would mean is that Frazell would not have been taxed on the net profits interest at the time he "received" it (November 1955, the end of the payout period), but only as the partnership profits were actually earned over a period of time. But while the *receipt* of a bare right to future income (*i.e.*, the net profits interest) may not be a taxable event, the present realization of that income through an anticipatory sale of the right plainly is such an event. Accordingly, the value of the W.W.F. stock is no less taxable when received by the taxpayer in exchange for a net profits interest in the partnership than it would be when received in exchange for an executory interest in the partnership capital, as discussed above.

his capital interest in income in that year, the Commissioner—probably because that year was closed[4]—determined that, although there was no net profit from the venture, distribution to the service partner was income when the venture was terminated in 1948. The court of appeals correctly held that the distribution was a return of the service partner's capital and, since the distribution was less than the capital share, no income resulted. So also in *United States* v. *United States National Bank*, 239 F. 2d 475 (C.A. 9), the holding that property received upon the dissolution of a joint venture was a return of capital necessarily implied that the taxpayer became possessed of a capital interest in the venture at some time prior to its termination.[5]

3. There is no other occasion for review. The decision below depends upon the terms of the particular agreement. The issue is the oft-litigated scope of the gross income provisions of the Code (Section 61). No question of the taxation of partnership distributions (*e.g.*, §§ 721, 731) or of the tax effects of the contribution of property to a corporation (*e.g.*, § 351) is involved. While it is true that "joint ventures" are common in oil and gas financing and production, that term embraces a wide variety of contractual relationships, and the tax treatment of each arrangement depends upon its own particularities.

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[4] See *Farris* v. *Commissioner*, 22 T.C. 104, 112.

[5] *Kasishke* v. *Baker*, 146 F. 2d 113 (C.A. 10), certiorari denied, 325 U.S. 856; *Kasishke* v. *Keppler*, 158 F. 2d 809 (C.A. 10); and *Kaye* v. *Smitherman*, 225 F. 2d 583 (C.A. 10), certiorari denied, 350 U.S. 913, are not tax cases, and deal only with the existence of a joint venture, a fact which the court below assumed to exist here. (Pet. 48.)

## CONCLUSION

For the reasons stated, we respectfully submit that the petition for certiorari should be denied.

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MARCH 1965.

U. S. GOVERNMENT PRINTING OFFICE, 1965